

Assessing The European Financial Crisis

Law360, New York (January 03, 2012, 5:31 PM ET) -- The crisis in the euro zone continues to create myriad risks and uncertainties. While it is not possible to predict the change in the euro zone that will result from the crisis, it is clear that change will occur. This article provides a high-level framework to assist market participants in evaluating and responding to the legal, regulatory and policy ramifications of this crisis.[1]



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Potential Outcomes in Europe

Crisis Resolves Favorably

Efforts undertaken within the euro zone cause the crisis to abate without permanent disruption of the euro zone or of the EU itself. This could include a decision by the European Central Bank to inject expansive liquidity into the European financial system — both by repurchasing sovereign debt in unlimited amounts and by injecting capital into euro zone banks. By printing money as necessary to take these steps, the ECB would likely keep interest rates low on a relative basis in the most vulnerable member states, but would risk stoking inflation across the euro zone.

Crisis Does Not Resolve Favorably

Efforts to resolve the crisis in the euro zone could fail. Market patience would dictate whether the scenarios listed below would develop, and how severe such results would be.

1) The viability of the EU banking system is threatened

The euro zone could remain in its current form, but the banking system in some or all member states would face ever-increasing pressure. Capital flight would increase, particularly in the most vulnerable economies. This could lead to more decisive action by euro zone leadership to attempt to prevent a run on banks in one or more member states.

2) Assisted exit by one or more member states from the euro zone

There is currently no mechanism for a member state to exit the euro zone short of leaving the EU. However, it is possible that a euro zone exit could occur either (1) through mutual agreement as a condition to any negotiated restructuring of a member state's sovereign debt or (2) through an exit that is compelled by euro zone leadership or by the EU itself (for example, as a consequence of a consensual default by the member state).

3) Unilateral withdrawal of one or more member states from the euro zone

A member state could unilaterally withdraw from the euro zone. In contrast to a negotiated exit, this would likely be associated with an uncontrolled default by the exiting member state.

4) Dissolution of the euro

In this "nuclear" scenario, the euro would cease to exist as a currency. Member states of the former euro zone would most likely create their own currencies. Any obligations denominated in euro would likely become payable in the relevant replacement currency. We expect that this would only occur in an uncontrolled manner, as opposed to as a policy choice by EU leadership if other options existed.

Any member state no longer using the euro as its currency would need to adopt and implement legislation creating its own currency. In countries with vulnerable economies, rapid devaluation of that currency would be expected, stressing the banking system. That country would almost certainly need to implement currency controls to prevent bank runs and capital flight (which are effectively prohibited under current EU treaties).

Inflation, particularly within weaker countries, would occur. These pressures could lead to a potentially severe recession across the euro zone as banks would further restrict lending to reduce their balance sheets and thus ameliorate the deterioration in their capital position caused by the devaluation of sovereign debt they hold.

Potential Implications for Companies

While we cannot predict the outcome of the euro zone crisis, we believe that change in economic policy in Europe in the near term is a given. The status quo is not sustainable, and if euro zone leadership does not implement appropriate change, the markets will force change in a less controlled and potentially more disruptive manner. Markets are global to a far greater extent than was the case for any prior currency conflagration, so these issues will likely have global ramifications.

Macro Considerations

- China is a significant exporter to the euro zone. Economic distress in Europe could impair growth and profitability in China as exports, and the value of the euro against the yuan, decline. Japan could suffer similar impairments. India is likely to be less affected as its trade volumes with the euro zone are not as significant.

- Several countries (e.g., Switzerland, Denmark) use the euro as a reference point for their currency management efforts. Such a country may shift to a different referent currency (or currencies), or decouple its currency altogether, affecting the relative value of that currency.
- The U.K. may be perceived as a safer haven than is currently the case, both because it retains the ability to deflate its currency to enhance competitiveness and also because the government's proposed crisis response has been viewed as credible. However, the U.K.'s decision to remain outside the EU's collective actions increases the possibility that the U.K. becomes more marginalized within the euro zone, and that the U.K.'s ability to influence the direction of potential financial services regulations is impaired.
- The U.S. dollar will likely be perceived to be a safer haven than the euro (the recent downgrade of the dollar notwithstanding). This could further increase the value of the dollar against the euro and, perhaps, other currencies, thus affecting price competitiveness of exports as well as the value of nondollar cash flows to entities the functional currency of which is the dollar.

Micro Considerations

Business Risks

Are any aspects of a company's business particularly susceptible in the event of a serious disruption of the euro currency or in the euro zone generally?

Difficulties In Hedging Exposure to the Euro

An obvious strategy is to enter into foreign exchange transactions designed to hedge exposure to the euro. However, it is already expensive to take short positions against the euro, and those costs are likely to increase as difficulties in the region persist.

Disruption in Payment Patterns

Payers in the euro zone that operate primarily in euro are likely to take longer to pay amounts due. Payers with functional currencies other than euro but with operations and cash flows in euro will seek to pay obligations in euros to take advantage of the decline in value of the euro. Payees in the euro zone with receivables denominated in safe-haven currencies are likely to push for accelerated payment in the appreciated non-euro currency.[2]

Impact on Location of Free Cash Balances

There is increasing concern that large European banks and custodians may face liquidity issues. It is also possible that, in the event of a full-blown crisis, clearance and settlement systems could become clogged by surging volumes as market participants seek to reposition cash or other assets, which could delay access to assets.

Further Contraction of Financing Alternatives

Bank financing is a more important source of funding in Europe than in the United States. European banks are facing significant increases in core Tier 1 capital requirements, and recently updated stress tests in Europe make clear that these banks face significant capital shortfalls. Given the unattractiveness of raising equity in current markets, it is expected that a significant component of capital compliance will be balance sheet reduction, which entails a further reduction in lending.

Shift in Counterparty Credit Risk

Counterparty credit risk may deteriorate for euro zone counterparties — customers, banks, derivatives counterparties and intermediaries such as clearance and settlement systems and custodians. Extant hedging transactions could cease to be effective risk mitigants if the counterparty's ability to perform is called into question.

Considerations Regarding Existing Contracts

It may be difficult to amend existing contracts to clarify ambiguities arising from the euro crisis, as the difficulty in predicting outcomes would complicate efforts to enhance contractual certainty. However, companies with material contracts that could be affected by disruptions in the euro zone may find it prudent to analyze those contracts in advance of the onset of any disruption.

Considerations include:

- For contracts denominated in euro, how is the currency defined? A reference to the “euro as adopted by the European Union” may produce a different result than a reference to “the Euro as used in [name of country]” if that country were to exit the euro zone.
- Will any scenario trigger exit or termination rights for or against the company? Would a material adverse change, force majeure or frustration of contract clause (or comparable common law principle) be triggered? If so, are any such rights automatic, such that the contract can terminate without prior knowledge or action?
- Are notice provisions triggered? Will failure to provide required notice constitute an event of default or otherwise adversely affect contractual rights?
- In financing or similar agreements, would provisions regarding repricing of interest rates or other payment obligations be triggered?
- What is the governing law and place of payment under the contract? In many jurisdictions, principles of currency law (“lex monetae”) provide that the law of the home country of the contractual currency govern as to the identity and composition of the contractual currency, rather than the law that otherwise governs the contract.[3]
- If a company has the right to break contracts due to the euro zone crisis, does it face any reputational or similar risk if it in fact exercises such a right?

Modification of Contract Forms

Consider adjusting key terms for new contracts. The definition of contractual currencies, locations for payment, price source references, and termination provisions in the event of currency disruption, are among the provisions meriting enhanced focus.

Technological Changes

Consider logistical issues such as reprogramming computer systems, revising books and records to support subsequent auditor verification, recalibrating ATMs, vending machines and other equipment calibrated to a given currency, and, for companies that hold large amounts of currency in physical form, converting from euros to the replacement currency.

Disclosure Considerations

If the company is publicly held and has forecasted economic results, do those disclosures need to be reconsidered? Are there any other disclosure considerations (such as risk factors relating to the potential impact of the euro zone crisis) that may be warranted?

Safety considerations

Consider potential security concerns for in-region employees and contractors should social unrest occur.

Crisis Management

Evaluate the company's crisis management preparedness if not already in place, consider setting up an internal crisis management team focused on the euro crisis, and also evaluate whether outside advice might be warranted.

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[1] This article is not intended to advise on specific business strategies .

[2] We note that there is a significant shortage of US dollars in markets outside of the United States, particularly in Europe, notwithstanding the recent coordinated expansion by the Federal Reserve and other non-EU central banks of US dollar swap lines with the ECB. This will further incent payees to insist on payment of receivables in dollars rather than euros.

[3] This could present ambiguity if EU law was deemed to constitute *lex monatae* with respect to the euro, as that would differ from the law governing the successor currency in the event a country withdraws from the euro zone and introduces a local currency.

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